SPECIAL REPORT for the Honorable Mayor and City Council of the City of San Jose

CITY OF SAN JOSÉ CALIFORNIA FOUNDED 1777

ARTHUR YOUNG & COMPANY

September 17, 1984

I. COUNCIL SUMMARY

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We have prepared this Council Summary in the belief that the various failures and deficiencies described in the body of this report can only be understood by focusing on the real nature of the investment activity conducted by the City of San Jose. The failure to properly understand this activity, and consequently to implement appropriate procedures, policies, controls and reporting mechanisms led to the situation in which the City now finds itself.

In our experience, municipal investment policies are very conservative in that they:

- Provide for the protection and safety of the municipality's invested funds
- Provide funds to meet the municipality's cash requirements (essentially serving as a buffer between the timing of revenue sources, such as tax payments, and expenditures, such as payroll)
- Earn a reasonable rate of return on the invested funds, but not at the expense of the first two objectives.

Typically, the municipality will accomplish these objectives by investing according to the following guidelines:

- Investments are predominately short-term
- Investments are made so that the municipality's cash requirements are satisfied by the maturity of securities in the portfolio
- Investments are usually made only in the safest instruments, such as:
  - Obligations of the United States Treasury and agencies of the Federal government
  - Certificates of deposit
  - High quality commercial paper
  - Bankers' acceptances
  - Repurchase agreements

COUNCIL FINANCE

We have proposed that Council finance, in the [illegible] the various facilities and activities we [illegible]. [illegible] of this report [illegible] only an [illegible] of the next report of the investment activity [illegible] of the land. The [illegible] these activities and [illegible] the procedures [illegible] and of the [illegible] of which [illegible] itself.

In our experience, municipal land-owner policies are [illegible] comprehensive in their scope:

Provide for the protection and enhancement of the municipality's invested lands

Provide funds to meet the municipality's cash requirements (essentially serving as a buffer between the timing of revenue receipts, e.g. tax payments, and expenditures, such as salaries)

Earn a reasonable rate of return on the funds, but not at the expense of the first two objectives.

Typically, the municipality will pursue the above objectives by investing according to the following guidelines:

Investments are undertaken only short-term

Investments are made so that the municipality has a ready liquidity, the maturities or liquidation of investments of [illegible] in the portfolio

Investments are usually made only in the safest investments, such as:

- Obligations of the United States Treasury and agencies of the Federal government
- Certificates of deposit
- High quality commercial paper
- Bankers' acceptances
- Repurchase agreements

Although the City of San Jose's investment portfolio consisted of the instruments described above, the investment strategy that it was pursuing (described below) contained a high level of risk and was speculative in nature.

As early as 1981, there is evidence that the City's portfolio managers had shifted their objectives from those of conservative municipal portfolio management (as described above) to those of attempting to earn both trading profits and a high rate of return on its invested funds. The investment activities used to increase the return on its portfolio included:

- Contracting with dealers to buy securities but selling the same securities before having to tender cash in settlement of the purchase transaction

  Generally, purchased securities had several day settlement periods between "trade date," when the committment to purchase was made, and "settlement date," when cash was actually tendered in exchange for the security. If the market value of the security increased between trade date and settlement date, the City had the opportunity to realize a profit on the transaction without ever disbursing funds to acquire the security. However, if the market value of the security declined between trade date and settlement date, the City had the risk of incurring a loss, and owing money to the broker or paying for and taking the security into the portfolio at a cost in excess of its then fair market value. These types of transactions are a form of speculation on future interest rates.

- Investing in long-term securities

  The market value of longer term securities (for example, those with maturities of ten to thirty years) tends to be more sensitive to changes in the general level of interest rates than the market value of shorter term securities (for example, those with maturities of less than one year). The City had substantial holdings of long-term securities that were acquired, according to the Treasury division employees that we interviewed, not with the intent of holding them to maturity, but rather with the intent of

selling them at a profit following an anticipated decline in the general level of interest rates. Interest rates, however, increased, leaving the City with large unrealized losses in the portfolio. Current cash requirements could not be met without sale of these long-term securities. Sale of the securites converted the unrealized losses into realized losses.

- Using leverage (borrowing) to increase the amount of funds the City had invested

  The City had a significant position in securities that were financed by reverse repurchase agreements. The City entered into these positions in anticipation of increases in the market value of the securities, which would result from anticipated decreases in the level of interest rates and would allow them to realize a profit on the security without actually disbursing cash to acquire it. When the market value of the securities declined instead (due to the general increase in the level of interest rates), the City incurred significant losses in the market value of these positions. These losses were realized through payments (referred to as "haircuts") to broker/dealers or resulted in paying for and taking the securities into the portfolio at costs in excess of their market value.

The investment activity engaged in by the City was very different in nature from the activity one would expect in a conservative municipal investment portfolio. The City was aggressively engaged in sophisticated debt securities trading, including use of complex leverage techniques, with the intent of maximizing total yield on the investment portfolio. The City's overall procedures, policies, and controls were not designed with this activity in mind and were not adequate to identify or control the risk inherent in this activity. Essentially, there was a failure at all levels of City government to recognize this difference or the speculative nature of the City's investment activity, and either curtail it or install appropriate management systems to control it. This failure is evidenced by:

- City Investment Policy

  The City's investment policy, while specifically prohibiting speculation, did not adequately define speculation or contain detailed provisions prohibiting the specific transactions the City was engaged in. To our knowledge, the City's investment policy was never formally reviewed or ratified by the City Council.

- Investment Procedures and Controls

  The investment procedures and controls in place in Treasury and Accounting were inadequate to control and manage the City's investment activity. The unrealized gain/loss position was not known. Trading gains and losses were not segregated from interest income or expense. Generally, the ultimate profitability or loss on an individual investment transaction was not known and the amount of outstanding commitments due to the various leverage techniques was not known.

- Management Reporting and Review

  The reports prepared by Treasury division employees for City management did not adequately disclose the nature or scope of the City's investment activities. Although certain statistical and numerical data was provided in the reports that would have permitted a reader to identify the situation as unusual, the reports did not specifically address the risk inherent in the approach being taken. Basic information regarding gains and losses (realized and unrealized), gross profits and gross losses from trading activity, and the amount of commitments to buy or sell securities was not known (see above) and consequently could not be reported. As a result, there was no effective management review of the City's investment activity, and the portion of the City's activity (mainly the increasing average maturity of the investment portfolio) that could have been detected by a review of the existing reports went unnoticed.

- Internal Audit

  Internal Audit, in its review of the Treasury division's investment activity and its report thereon in early 1983, failed to recognize the nature of the City's speculative investment activity. The objectives set out for the review, if met, would have identified the true situation that existed. Failure in this regard appears to have been due, in part, to a combination of a lack of expertise and inadequate controls over the report-drafting process.

- Management Responsibility and Authority

  The investment portfolio is the largest recorded asset of the City. Responsibility for managing a portion of the portfolio was delegated to an employee four management levels below the City Manager. Personnel actually responsible for Treasury activity did not appear to have the training, background or requisite understanding to properly execute their management responsibilities. Review of their performance was inadequate and limited, in part, due to the lack of information identified above.

The remainder of this report contains our specific findings and recommendations with regard to the general issues discussed above.

II. INVESTMENT POLICY

II. INVESTMENT POLICY

We reviewed the various City Council resolutions and government code sections related to the authorization of investment activities by the Finance Department, and interviewed current and former Finance Department officials. Our findings and recommendations are listed below:

Findings

- A statement of investment policy for the City of San Jose was prepared by the Chief of the Treasury and submitted to the Director of Finance in May 1979. This statement of investment policy was updated annually if additional types of investments had been approved by government code. The most recent version of the statement was dated May 1983.

- The original statement of investment policy was based on an article published in a newsletter of the Municipal Treasurer's Association of the United States and Canada. The article referred to the investment policy of Boulder, Colorado.

- To our knowledge, the policy was not officially adopted by the City Council as City policy. However, it was sent to the then City Manager, James A. Alloway, for comments and his concurrence. We have not found any record of his response.

- The criteria for selecting investments and the order of priority in the statement of investment policy were:

    1. Safety

    2. Liquidity

    3. Yield

  In addition, the statement of investment policy includes provisions that state that the City "does not buy stocks; it does not speculate or deal in futures or options," and "longer term investments (over one year) are generally limited to maturities of five years or less, and only rarely do they extend beyond ten years."

This informal policy was not adhered to and investment decisions were made on the basis of yield.

- A weekly Investment Committee met to discuss investment decisions in the late 1970s. This Committee was discontinued when the volume of trading on a daily basis rendered its operation as a vehicle for making investment decisions too cumbersome.

- In order to provide a measure of review of the investments being made, the Chief of Accounting or his designee signed and currently sign the internal City confirmation notice after the investment has been made. However, the Chief of Accounting indicated that his signature was merely perfunctory, and was not intended to provide any level of control or review of the City's investment activity.

Recommendations

- The development and maintenance of the City's investment policy and the short-term and long-term strategies require the expertise of specialists. As discussed in Section C of the policy outline shown below, we believe that the City should retain the services of an independent investment advisor. This advisor should have the following responsibilities:

  - Assisting the City with the development and maintenance of the formal investment policy

  - Assisting the City with the periodic development and review of the short-term and long-term investment strategies

  - Assisting the City with evaluation of the performance of the City's portfolio

  - Educating the City Council and City management on the nature of the City's investment activity so that they may effectively discharge their responsibilities as defined in the City's investment policy.

- The City should develop and formally adopt an investment policy to guide the development, implementation, and review of the City's short-term and long-term investment strategies. Formalization of an investment policy will require consideration of many issues and factors, including the following:

- Degree of risk that the City is prepared to accept

- Expertise of City personnel executing the investment function

- Use of outside investment advisors

- Ramifications of various policy alternatives

. The City's investment policy should be established so that it reflects desirable policy for the future. While this may mean that the current composition of the portfolio violates policy, these violations can be reported and monitored until they are eliminated.

. The City should develop its investment policy along the lines of the outline shown below. While this outline is not intended to be an exhaustive listing of all the elements of the City's investment policy, it does list important issues that the City should consider when developing its own policy. It is likely that, during the process of developing the formal policy, additional issues not identified in this outline may arise. It is important that all significant issues be identified and addressed appropriately in the City's formal investment policy.

OUTLINE FOR DEVELOPING A FORMAL INVESTMENT POLICY

A. <u>STATEMENT OF OBJECTIVES</u>

This section of the investment policy should identify the objectives and importance of the investment function to the City of San Jose. The following issues should be addressed in this section.

1. <u>Overall Risk Profile</u>

This section of the investment policy should state, in general terms, the level of risk that the City is willing to tolerate in its investment portfolio. All investment activity is accompanied by some degree of risk; usually, investments with greater degrees of risk have a correspondingly greater expected return to compensate the investor for bearing that risk. It is therefore important for the City to determine

for itself the level of risk it feels is appropriate for its investments, since no investment strategy can ignore the implications of risk in the capital markets.

The City's three investment criteria of safety, liquidity, and yield are inadequate by themselves to define the City's overall risk profile. They do not cover every aspect of risk that the City should be concerned with, and they do not address the risk implications of the different methods that an investor can use to achieve safety, liquidity, and yield. The City should expand upon its discussion of the three investment criteria to include statements on how it intends to achieve them, as presented below:

<u>Safety</u>

The City appears to be mingling two important concepts that should be discussed separately in any investment policy - preservation of the invested capital (i.e., protection from losses due to changes in the market value of the City's investments), and physical security of the investments (i.e., safekeeping). A discussion of these different types of safety follows:

- Preservation of Invested Capital

  Money invested in the debt securities market is at risk of loss from two distinct sources - interest rate risk and credit risk. Interest rate risk is the risk of the market value of the security fluctuating due to changes in the overall level of interest rates. If the general level of interest rates increases, the market value of debt securities will tend to decline. Similarly, if the general level of interest rates declines, the market value of debt securities will tend to increase. In general, longer-term securities are more volatile with regard to interest rate changes; that is, they will have greater variations in their market value due to a given

change in the general level of interest rates than will short-term securities. The City can mitigate the effects of interest rate risk in its portfolio by:

- Structuring its portfolio so that securities mature to meet its cash requirements, thereby avoiding the need to sell securities on the open market prior to their maturity, and

- Investing primarily in shorter-term securities, unless it is anticipated that the long-term investment can be held to maturity (for example, to meet a specific anticipated cash outflow in the future, such as a long-term capital project).

Credit risk is the risk of loss due to the failure of the security issuer or backer. In general, the City can mitigate credit risk by adopting a policy of investing only in the safest types of securities, by qualifying the financial institutions with whom it will transact, and by diversifying its portfolio so that the failure of any one issuer or backer will not place an undue financial burden on the City.

- Physical Security of Investments

The physical safekeeping of investments is important to the overall protection of the City's investment portfolio, and should be discussed in this section of the investment policy as another element of security that the City needs to define and provide for in its investment management program. Safekeeping requirements are discussed in greater detail in Section F of this investment policy outline.

Liquidity

The current investment policy does not identify or distinguish between the different ways the City can achieve liquidity in its portfolio - static liquidity and dynamic liquidity. There are important differences between these two types of liquidity, and the City's investment policy must distinguish between them to be complete. A discussion of static and dynamic liquidity follows:

- Static Liquidity

  Static liquidity is achieved by having securities in the City's portfolio mature to meet the City's cash requirements. Static liquidity can be obtained, therefore, by constructing an investment portfolio of primarily short-term securities that mature at the same time the City needs cash from the portfolio. As discussed above, this type of investment strategy would also mitigate the interest rate risk in the City's portfolio, since securities are held to maturity and do not need to be sold to liquidate the investment.

- Dynamic Liquidity

  Dynamic liquidity is achieved by owning securities with active secondary (resale) markets. An investment may be liquidated by selling the securities when cash is required. As described above, this type of liquidity does expose the City to interest rate risk, because the value of the security may be greater than or less than its original acquisition cost, if the general level of interest rates has changed since then. It is desirable to have dynamic liquidity in the portfolio because of the flexibility it provides; however, it is not necessarily desirable to rely solely on it for liquidity because it exposes the portfolio to interest rate risk.

Static liquidity and dynamic liquidity are not mutually exclusive. It is possible (and, for a municipality, usually highly desirable) to construct an investment portfolio that has a high degree of both static and dynamic liquidity. This is accomplished by acquiring securities whose maturities are matched to the forecasted cash flow requirements, providing static liquidity. Also, by investing primarily in highly marketable securities, the portfolio also has a high degree of dynamic liquidity, providing liquidity via sale of securities should conditions (such as forecasted cash requirements) change.

Yield

The City's investment policy does not distinguish between yield from interest earned on investments and yield from profits made by trading in securities. The differences between these two types of yield and their implications are discussed below:

- Interest Income

  The normal objective of a municipal investment fund is to earn a reasonable rate of return on invested funds through interest income. Yield on the portfolio should be of secondary importance in relation to safety and liquidity (as defined above). Investments are made only in relatively low-risk (and therefore low-return) securities, in anticipation of earning a fair return on the investment relative to the risk being borne.

- Trading Profits

  In the fiscal year 1982-1983, the City made a substantial return on its portfolio by engaging in trading activity for the purpose of profiting from the increase in the market value of debt securities due to decreases in the general level of interest rates. This activity was not without attendant risk, however, as subsequent events demonstrated.

While it is reasonable for a municipality to realize some trading profits (and incur some trading losses) due to occasional restructuring of its portfolio (for example, by selling a long-term security originally planned to be held to maturity because of a current need for cash), it is not appropriate for a municipality to be engaged in trading activity for the sole purpose of realizing trading profits, which essentially amounts to speculation on the future price of securities.

In order to prevent a recurrence of the events culminating in the City's enormous losses, the investment policy should identify and specifically prohibit trading activity engaged in solely for the purpose of realizing profits. In addition, other sections of the policy, such as those identifying reporting and review procedures and responsibilities (sections D and E of this outline) should include specific provisions to monitor the City's trading activity, so that City management is informed about the level of and reasons for any trading engaged in by the City, and can distinguish between normal and reasonable trading activity (as described above) and unreasonable activity, such as that of the recent past.

The formal investment policy should identify the City's overall risk profile in terms of the specific types of risk, as they relate to safety, liquidity, and yield. By including this discussion in the "Objectives" section of the policy, the detailed sections that follow (such as those that should describe specific investment guidelines, as discussed in Section B of this outline) will have an overall context making the various sections into a unified and consistent policy.

2. Time Frame for Investment Decisions

This section of the investment policy should define the time horizons that should be considered when developing the short-term and long-term investment strategies. Investment in long-term securities is not necessarily undesirable, since it can yield higher returns on the City's investments, and could be permitted provided that certain criteria are met, such as the matching of maturities to forecasted cash requirements.

3. Definition of Surplus Cash

This section of the investment policy should establish a definition of surplus cash that falls within the scope of the investment management program. The policy should be specific as to whether, and under what conditions, borrowing via investment vehicles, such as reverse repurchase agreements, is to be permitted.

Reverse repurchase agreements are legitimate investment vehicles both for arbitrage and for financing short-term cash requirements, if appropriately managed and if entered into in accordance with a City policy authorizing them for these specific uses. (For example, if a specific cash requirement preceeds the maturity of a security intended to satisfy that cash requirement, it may be advantageous under certain circumstances to initiate a reverse repurchase agreement pledging the security as collateral, rather than selling the security prior to its maturity. Proceeds from the maturity of the security could then be used to close out the reverse repurchase agreement.) However, the investment policy should specifically prohibit using reverse repurchase agreements as a means of financing the acquisition of securities that the City does not intend to bring into its portfolio.

B. INVESTMENTS

This section of the investment policy should identify the types of investments the City will be investing in. It should include at least the following major sections:

1. Allowable securities

2. Composition of portfolio (maximum allowable percentage of various security types, to provide diversification so that the failure of any one issuer will not place an undue financial burden on the City)

3. Qualification of security issuers or backers

4. Qualification of the brokers, dealers, and financial institutions with whom the City is to do business. For example, the City might restrict their investing to the largest banks or Savings and Loans as measured by assets and return on equity, and to the largest brokers and dealers as measured by their total capitalization.

5. Maturity guidelines (specific long-term and short-term maturity standards may vary depending upon the long-term and short-term strategies being pursued at the time)

In general, there is no reason for the City not to invest in all the securities permitted under Section 53601 of the California Government Code provided that:

1. The maturity of those securities matches the City's cash requirements.

2. Investment policy is adhered to.

3. Investment activity is monitored and controlled by the responsible officials.

4. There is no speculative investment activity, which would include making investments where the risk of the City losing its invested capital or a part thereof is greater than the City is willing to accept.

C. <u>STRUCTURE AND RESPONSIBILITY</u>

This section of the investment policy should define the overall structure of the investment management program, and should identify the individuals and groups responsible for all aspects of the investment management process. It should address the following topics:

1. <u>Structure of the Investment Department</u>

This section should define the structure of the investment function within the City's Finance Department. The various committees and individuals responsible for aspects of the investment management process should be identified, and reporting relationships between the groups and individuals should be defined. The Department should be restructured to eliminate the serious control weaknesses caused by a lack of segregation of responsibility among various Treasury employees (as described in Section III.2 of this report, "Segregation of Duties").

The membership of any investment committees and the City's use of an independent advisor, if it so chooses, should be established in this section. As discussed elsewhere in this report, we recommend that the City retain the services of an independent investment advisor to assist them in developing and implementing its investment policies and strategies.

2. <u>Responsibilities of the City Council</u>

The City Council's responsibility for the overall management of the investment program should be defined in this section. Their responsibilities should include approval of the City's investment policy and monthly review of any violations of or exceptions to that policy.

3. <u>Responsibilities of the Investment Committee</u>

If an investment committee is required by the investment policy, as we believe one should be, its membership and responsibilities should be defined in this section. This committee should include the Chief of Treasury, the Director of Finance, the Assistant City Manager, and the independent investment advisors. Its responsibilities should include:

- Recommendation of investment policy
- Setting of long-term and short-term investment strategies

- Review of investment activity and performance

4. Responsibilities of the City Manager and Assistant City Manager

   The City Manager and Assistant City Manager's responsibilities for the investment management program should be defined in this section. They should include the review of monthly investment reports with the Director of Finance, with particular attention paid to policy violations.

5. Responsibilities of the Director of Finance

   The Director of Finance's responsibilities for the investment management program should be defined in this section. They should include detailed review and monitoring of investment activity with the Chief of Treasury, and prior approval of any policy violations or exceptions.

6. Responsibilities of the Chief of Treasury

   The responsibilities of the Chief of Treasury should be defined in this section. They should include the investing of funds for the City in compliance with the City's investment policy, and in accordance with instructions from the City's investment committee and review and approval of the City-prepared confirmation. They should also include the preparation of the monthly investment reports and the detailed review of those reports with the Director of Finance.

7. Responsibilities of the Chief of Accounting

   The Chief of Accounting's responsibilities for the investment management program should be defined in this section. They should include the detailed review of the account reconciliations related to the City's investment accounts, and the reporting of any policy violations to the Director of Finance.

8. Responsibilities of Other Individuals or Groups

Any other individuals or groups who have responsibilities for the investment management function should be identified in this section. These should include independent investment advisors whose recommended responsibilities, as previously discussed, should include:

- Assisting the City with the development and maintenance of the formal investment policy

- Assisting the City with the periodic development and review of the short-term and long-term investment strategies

- Assisting the City with the evaluation of the performance of its portfolio

- Educating the City Council and City Management on the nature of the City's investment activity so that they may effectively discharge their responsibilities as defined in the City's investment policy

D. REPORTING

This section of the investment policy should specify the types of information that should be reported, to whom it should be reported, and the frequency with which it should be reported. (Specific recommendations regarding the content and review of the investment reports are contained in Section IV of this report.)

E. REVIEW

This section of the investment policy should specify the responsibilities and procedures for review of the investment management function. It should address at least the following topics:

1. Policy Review

The timing of and responsibility and procedures for the review and maintenance of the City's overall investment policy should be specified in this section. As discussed in Section C of this

outline, "Structure and Responsibility," we suggest that the Investment Committee be responsible for reviewing and modifying the policy as appropriate, and the City Council should be responsible for reviewing and ratifying it. The policy should be reviewed and ratified annually (or more frequently if circumstances dictate).

2. <u>Long-term and Short-term Strategy Review</u>

The timing of and responsibility and procedures for the review and maintenance of the City's long-term and short-term investment strategies should be specified in this section. We suggest that the investment strategies be reviewed and revised as appropriate by the investment committee, reviewed and approved by the City Manager, and reviewed and ratified by the City Council. This review should take place quarterly (or more frequently if circumstances dictate).

3. <u>Long-term and Short-term Investment Performance Review</u>

The timing of and responsibility and procedures for the review of the performance of the City's long-term and short-term investment portfolios should be specified in this section. We suggest that the performance of the investment portfolio be reviewed in detail by the investment committee, and in summary by the City Manager and City Council. The performance of the investment portfolio should be reviewed monthly.

F. <u>SAFEKEEPING</u>

This section of the investment policy should specify the safekeeping requirements of the City. It should cover the following topics:

1. What institutions may hold City securities in safekeeping

2. What securities should be in safekeeping

3. How securities in safekeeping should be controlled

4. How securities in safekeeping should be held (street name or city name)

5. Circumstances under which the City should take possession of securities under repurchase agreements.

III. CONTROL ISSUES

III. CONTROL ISSUES

We reviewed the procedures and controls relating to the following investment activities under the control of the Treasury division:

- Cash forecasting
- Making investments (including investments in reverse repurchase agreements)
- Generating cash from investments (via maturity or sale)
- Accounting for investment transactions
- Receipt of interest

Our review revealed several deficiencies in the procedures and controls relating to the activities listed above. Our findings and recommendations for improving procedures and controls relating to the investment function are discussed below:

1. WIRE TRANSFERS

Findings

- Wire transfers (used to transfer funds from the City's bank to dealers' banks in settlements of investment transactions) are executed by Wells Fargo upon the verbal request of a City employee. Upon receiving a verbal request to transfer funds from an authorized City employee, the bank executes the wire transfer without verifying the validity of the transaction with a second City employee.
- While only certain employees are authorized by the City to initiate wire transfers, there are no restrictions on the accounts to which they may transfer funds or the amount of funds that may be transferred in a single transaction.

Recommendations

- Whenever possible, the City should institute the use of preformatted wire transfers that restrict the transferring of funds to pre-authorized accounts only. Preformatted wire transfers could be executed in-house using the City's microcomputer, helping to mitigate the possibility of fraudulent or accidental transfer of funds to the wrong account.

- When the City needs to transfer funds to an account not previously approved (thereby forcing the City to initiate the transaction verbally, as is currently being done), the transaction should be approved prior to transfer of funds. The bank should be required to confirm the transfer request by calling back a second City employee who has the responsibility to check the account to which funds were transferred. These employees should not be responsible for or involved in investing City funds.

2. SEGREGATION OF DUTIES

Findings

- Within the Treasury division there are the following overlapping responsibilities related to the investment function:

    - Cash forecasting and cash management
    - Investing (buying and selling securities and other investments)
    - Initiating wire transfers
    - Preparing confirmations to document activity
    - Matching broker confirmations to City confirmations
    - Matching bank advices to City confirmations
    - Preparing the reports used by accounting to record haircuts and open reverse interest costs

- Calculating the gains and losses on transactions

- Preparing revenue vouchers

- Reconciling the Wells Fargo safekeeping account to Money Max (General Fund) and Pension Max (Retirement Fund)

. The overlapping of these responsibilities represents a serious control deficiency, and leaves the City at risk of loss due to unauthorized or fraudulent activity. Unauthorized wire transfers could be concealed by preparing internal documentation that would make the transaction appear to be valid.

Recommendations

. The City should separate the responsibilities of investment decision-making from the activities required to consummate (via transfer of funds or securities) and account for the transaction. In particular, the City should separate the responsibility for initiating the investment process from that of initiating wire transfers to pay for the investments.

. Broker confirmations and bank advices should be delivered directly to Accounting. Accounting personnel, not Treasury personnel, should be responsible for matching the City-prepared confirmation to the broker confirmation and bank advice.

. The Accounting division should account for all interest charges recorded and agree such to the related brokers' statements monthly.

. The Accounting division should maintain a numerical file of City confirmations for investments in the portfolio. The confirmations should be reconciled to Money Max on a monthly basis. To facilitate this procedure and improve the City's ability to track investment transactions, City confirmations prepared upon initial investment should be assigned the line number per the Money Max report. This would ensure that investment transactions would be assigned only one confirmation number throughout their term.

- As discussed in Section II of this report, "Investment Policy," the City should develop an investment policy that restructures the organization of the investment function to eliminate the overlapping responsibilities described above.

3. RECORDING REVERSE REPURCHASE AGREEMENTS

Findings

- Reverse repurchase agreements entered into by the City for the purpose of financing the security pledged as collateral for the reverse repurchase agreement were not recorded in the Money Max system or in the City's accounting records until the transaction was settled.

- Reverse repurchase agreements related to Retirement Plan investments were not recorded on the Pension Max system, since the Pension Max system was unable to accept negative amounts.

Recommendations

- If their use is continued, all reverse repurchase agreements entered into by the City should be recorded in either the Money Max system or the Pension Max system and in the City's general ledger. In addition, the City should record, in the Money Max or Pension Max system as well as the general ledger, any securities financed by entering into reverse repurchase agreements with the financed securities pledged as collateral. Monthly reconciliations should be prepared between the general ledger and Money Max or Pension Max systems to provide control over the City's transactions. Such a manner of recording transactions will provide City management with better information on the entire scope of the City's investment activities.

- Until the Pension Max system is modified to be able to accept reverse repurchase transactions, Treasury division personnel responsible for Pension Plan investments should manually record such transactions on the Pension Max reports to accurately reflect the status of the reverse repurchase transactions.

4. ACCOUNTING FOR THE REINVESTMENT PROCEEDS OF REVERSE REPURCHASE AGREEMENTS

Findings

- Reverse repurchase agreements are not accounted for in a manner that allows a calculation of the net gain from the interest arbitrage. Without reconstructing the specific activity from the City's records, it is not possible to determine whether the proceeds from reverse repurchase agreements are being used for reinvestment, nor whether the reverse repurchase agreement and subsequent reinvestment is in fact profitable, nor whether the maturities of the reverse repurchase agreement and the related security are matched.

Recommendation

- If the City continues to use reverse repurchase agreements as a short-term investment vehicle, it should implement a method of tracking the reverse repurchase agreements and the reinvestment of the related proceeds in a manner that will allow City management to review the profitability of the transactions. For example, the City could implement a reverse repurchase agreement ledger using spreadsheet software on the Treasury division's microcomputer and monitor the status and profitability of reverse repurchase agreements entered into for arbitrage purposes.

5. TRACKING SECURITIES USED AS COLLATERAL FOR REVERSE REPURCHASE AGREEMENTS

Findings

- The Money Max system is not used in a manner that identifies which securities have been pledged as collateral for reverse repurchase agreements, although these capabilities do exist. This increases the difficulty of reconciling the Wells Fargo safekeeping account to the Money Max reports, and makes it difficult to control the receipt of semiannual interest payments as they become due.

Recommendations

- If the City continues to use reverse repurchase agreements as a short-term investment vehicle, it should use the full capabilities of Money Max to identify the securities that have been pledged as collateral for reverse repurchase agreements. These include:

  - Flagging the security being pledged as collateral on the inventory listing produced by the system

  - Tracking the market value of the collateral pledged for reverse repurchase agreements

  - Changing the safekeeping location of the security pledged as collateral to show that it is being held by a broker

6. DOCUMENT MATCHING

Findings

- City confirmations that document a transaction may be processed and filed before the broker advice and safekeeping receipt are matched to them. There is no way of determining that all transactions in the City files have been matched to broker advices. This is an important control step for ensuring that all transactions are real and have been recorded.

Recommendations

- The broker advice, wire transfer advice, and the safekeeping receipt should be matched to the City confirmation by Accounting division personnel.

7. INVESTMENT ACCOUNT RECONCILIATIONS

The following comments relate to the reconciliations prepared by the Accounting division for the investment accounts. These accounts are listed below:

000-010000-15	Local Agency Investment Fund
000-010000-20	Time Deposits
000-010000-30	Other Investment (such as securities of the United States Treasury and of agencies of the United States Government)
000-010000-40	Purchased Interest
000-010000-60	Advanced Payment to Brokers
001-012400-10	Advanced Payment to Brokers
000-010000-80	Reverse Repurchase Obligations

We reviewed the April 1984 reconciliations of these accounts to determine their accuracy and completeness and have arrived at the following findings and recommendations:

Findings

- The April account reconciliations were not prepared on a timely basis.

- The Advanced Payment to Broker accounts (000-010000-60 and 001-012400-10), used to record payments made to and received from brokers that result from fluctuations in the market value of the collateral that secures the City's reverse repurchase agreements, are not reconciled to the detail accounting records that track such transactions. Per our review of the detail advanced payment schedule as compared to the general ledger accounts, we found that the City was unable to reconcile the balance by $614,461. Upon further review, we were able to determine that $249,910 represented an unrecorded liability to a broker and an unrecorded interest expense for the same amount. The exact cause of the remaining $364,551 unreconciled difference was not determined in our review. Its disposition may require an expense write-off during the current fiscal year.

- Per our review of the account reconciliations, items that require adjustments or corrections to the City's records are not properly reflected in the general ledger on a timely basis.

- The account reconciliations do not have any indication that they have been reviewed or approved by management personnel.

- The account reconciliations do not include copies of supporting documentation or written commentary on the procedures performed or the final results. This contributes to the following problems:

  - The reconciliations may be prepared without documenting an adequate understanding of the nature of the reconciling item, increasing the likelihood of errors.

  - The reconciliations are difficult to understand, and incomplete documentation makes them difficult to review.

<u>Recommendations</u>

- Reconciliations must be performed on a timely basis for the information that they contain to be useful to City management. The Accounting division should complete the reconciliations shortly after month-end; otherwise, City management will not be assured that all transactions are properly recorded.

- All investment related balance sheet accounts should be reconciled on a monthly basis to ensure the safeguarding of the City's assets.

- To ensure that the reconciliations are properly completed and that management approval has been obtained for any general ledger adjustments identified during the general ledger reconciliation process, the Chief of Accounting should review all investment account reconciliations on a timely basis and indicate his approval by signing the reconciliations.

- All items identified during the reconciliation process that require adjustments to the City's records should be reflected in the general ledger on a timely basis. All adjustments should be reviewed and approved by the Chief of Accounting.

- To aid in the tracking and reviewing of reconciliation amounts, complete supporting documentation for all reconciling items should be made a part of the reconciliation itself.

- Routine journal and revenue vouchers should be reviewed and approved as to account distribution and accounting treatment before being recorded to prevent misclassifications that will require correction at a later time.

- Monthly broker's statements should be reconciled to the Treasury division records, and the monthly Money Max report should be reconciled to the monthly safekeeping statement.

- Reconciling items should be traced and agreed to the reconciling items in the City's cash reconciliation, where appropriate.

8. QUALIFICATION OF DEALERS AND FINANCIAL INSTITUTIONS

Findings

- The City does not have a policy for qualifying dealers or other financial institutions with whom it is investing. This is an especially important issue for investments in repurchase agreements (where the legal status of the investment has not yet been resolved by the courts) and Certificates of Deposit (where the investment may exceed federal insurance limits).

Recommendations

- As discussed under "Investment Policy" in Section II of this report, the City should establish a policy for approval of institutions and dealers with whom it will conduct investment activity. For example, the City might restrict their investing to the largest and most secure banks and Savings & Loans measured by assets and return on equity, and to the largest and most secure brokers and dealers as measured by their total capitalization. It should be the responsibility of the Director of Finance (or other official, as identified in the policy) to approve and monitor this list (with input from the Chief of Treasury), and to revise it as appropriate.

- The City should establish the policy of annually communicating the City's written investment policy to all institutions that are approved to do business with the City. This will serve to inform the institutions of the limits of authorization of Treasury division personnel as well as the investment philosophy and goals of the investment program.

9. USE OF MONEY MAX AND PENSION MAX

Findings

- The Money Max and Pension Max systems have many features to facilitate portfolio management that are currently not being used by the City. For example, the systems have the following modules that are currently not being used or are underutilized:

  - Cash Flow Analysis
  - Portfolio Analysis
  - Interest Allocation

  In addition, the systems have features to assist the City in tracking reverse repurchase agreements that are not being used (as previously discussed). Because of the size of the City's portfolios and the complexity of the investment transactions, the City should be taking advantage of every feature the systems have available to improve the efficiency and effectiveness of its management of the portfolios.

Recommendations

- Education and training should be provided for appropriate Accounting and Treasury personnel on the uses and services available on the Money Max and Pension Max systems. In addition, City management personnel should familiarize themselves with the capabilities of the systems so that they may evaluate the effectiveness with which the systems are being used.

10. CHART OF ACCOUNTS STRUCTURE

Findings

- The chart of accounts used by the Accounting division did not contain provisions to

separately track gains or losses on the sale of securites, interest income, or interest expense. These elements were combined and reported as a single amount. As a result, City management was unable to detect the large losses from the sales of securities (generally as the result of pair-offs) and the growing amounts of interest expense until their total exceeded the monthly interest income received in February 1984. Prudent management would require the separation of all individual elements of income and expense in the accounting records and the management reports prepared from them.

Recommendations

- The chart of accounts should have separate income and expense accounts for the following data elements:

  - Interest income - received

    * reverse repurchase agreements
    * repurchase agreements
    * portfolio securities

  - Accrued interest income

    * reverse repurchase agreements
    * repurchase agreements
    * portfolio securities

  - Interest expense - paid

  - Accrued interest expense

    * reverse repurchase agreements

  - Gain on sale of securities

    * reverse repurchase agreements
    * portfolio securites
    * pair-offs

  - Loss on sale of securities

    * reverse repurchase agreements
    * portfolio securities
    * pair-offs

- Dealer fees and commissions

- Other investment expenses

Managerial reports generated from this data should disclose each item separately.

11. CASH FORECASTING

Findings

- Within the Treasury division, cash forecasting procedures consisted of forecasting the daily ending cash balances one day in advance. As a result, investment decisions were made in the absence of information about the amount or timing of even short-term cash needs. To make informed investment decisions, it is important to have accurate cash forecasts in order to match the maturity of current investment decisions to projected cash requirements.

Recommendations

- The City should institute both short- and long-range cash forecasting procedures to provide information regarding the City's projected cash surpluses or cash needs. A reliable system for cash forecasting will be necessary for the City to make informed investment decisions. In addition, it would reduce the frequency of situations that would require the City to use reverse repurchase agreements to meet unexpected cash short-falls.

- In conjunction with implementing better forecasting procedures, the City should consider reviewing all of its cash-handling operations and evaluate whether there are opportunities for improving the overall cash flow by improving the efficiency and effectiveness with which these operations are managed.

IV. MANAGEMENT REPORTING AND REVIEW

IV. MANAGEMENT REPORTING AND REVIEW

We reviewed the process for preparation and review of the Report of City Fund Investments prepared monthly by the Treasury division.

Findings

- The monthly Report of City Fund Investments was the only investment program management report regularly distributed outside of the Finance Department. Distribution included multiple copies to the City Manager for placement on the Council agenda, as well as copies to the City Auditor, Director of Finance, and Chief of Accounting. The June 1983 report also included, as a cover letter, an Investment Activity Report for Funds Managed by the City Treasury for Fiscal Year 1982-83.

- The monthly Report of City Fund Investments included a cover memo prepared by the Chief of Treasury and signed by the Director of Finance. This cover memo summarized the amount and percent of the idle funds invested, the effective year-to-date yield, the net interest received (including profits or losses received), the City Funds activity in numbers of transactions and Retirement Fund activity for the month. The remainder of the report was, for the most part, computer-generated by the Money Max system. This included two summary pages and a number of pages listing the securities that had been brought into the portfolio. The summary pages repeated some of the information described above and included information on the weighted average days to maturity of the portfolio and dollar value of transaction activity by type of investment.

- The monthly Report did not include those transactions in a "trading position" (securities for which the City had made a commitment to purchase but which had not yet settled) nor those securities acquired through an "open reverse" (the City "purchased" a security by "borrowing" funds through a reverse repurchase agreement collateralized by the security itself). These transactions were first included in the Report after the securities were acquired or the transactions settled.

- The monthly Report did not include trend or comparative data, which would have helped with an understanding of the information contained in the Report.

- While the monthly Reports did not disclose the full extent of the City's investments, they did contain sufficient detail to inform a reader that:

  - The City utilized reverse repurchase agreements prior to the passage of Council Resolution No. 56549 in May of 1983. (See Section VI "City Council Resolutions.")

  - The weighted average maturity of the City's portfolio exceeded ten years as far back as June 1983. Exhibit A shows how the weighted average maturity of the pooled investment portfolio increased dramatically during the summer of 1983, and reached a maximum during April 1984.

  - A major shift in the composition of the City's portfolio away from short-term investments, such as Banker's Acceptances and Time Certificates of Deposit, towards securities with maturites in excess of ten years, such as United States Treasury Bonds, occurred as far back as the Summer of 1983. Exhibits A and B show how the composition of the City's portfolio shifted during this period, and how the shift affected the weighted average maturity of the portfolio. Exhibits A and B were prepared directly from the monthly Reports and, as mentioned above, they do not include all transactions.

- Although the Reports alone would not have revealed the speculative nature of the City's investment activity, the information that they contained, as described above, clearly indicated that the City's investment strategy was in violation (with regard to maturity) of the investment policy described in Section II of this report under "Findings." Detailed preparation and review of the monthly Report was performed at too low a level in the organization; management review of the Report did not identify the deficiencies in the type of information being reported, nor did it detect violations of the City's investment policy with regard to liquidity.

- Beginning in 1983, the City was making significant cash disbursements for "haircuts" (the term used by City employees for payments made to brokers that resulted from fluctuations in the market value of the collateral that secured the City's reverse repurchase agreements) and "open reverse interest costs" (the term used by City employees for interest payments made to brokers on reverse repurchase agreements). "Haircuts" were included as part of the City's investment cost in the accounting records, but were not reported separately to City management on a regular basis. In addition, they were never recorded separately on the Money Max system. "Open reverse interest costs" were combined with interest income in the reports to City management and not reported separately. Exhibit C shows the dollar amount of "haircuts" and "open reverse interest costs," as reported by the Treasury division to the Accounting division, between January 1983 and May 1984. Exhibit C is included in this report to show the magnitude of the disbursements that were being reported by the Treasury division. Our procedures have revealed that these reports were not complete, in that they did not include all such disbursements. (Our recommendations regarding the recording and reporting of "haircuts" and "open reverse interest costs" are contained in this section and in Section III.10, "Chart of Accounts Structure.")

- Part of the reason for the inadequacy of the review of the monthly Reports was due to the nature of the activity being monitored. Knowledge of the investment activity being transacted and its implications to the City's overall investment program required specialized expertise.

Recommendations

- The City should develop new investment reporting procedures in conjunction with the definition of formal investment policies. In general, the new investment reporting procedures should include a succinct management summary that provides a clear picture of the status of the current portfolio position and the trading activity, if any, over the past month such that a non-financial executive can ascertain the extent to which the Treasury has adhered to the City's formal investment policies.

- The specific items to be reported will depend on the specific elements of the investment policy statement. At a minimum, however, we recommend that the management summary include the following items:

- Trend of average portfolio maturity (by month for 12 months)

- Maturity aging by type of investment

- Percentage mix of portfolio by type of investment

- Portfolio turnover rate and trend

- Separation of realized trading gains or losses from interest received on trading activity, if the City continues to engage in trading activity

- Reasons for and amounts of violations or exceptions to investment policy during the month being reported on, as well as prior violations or exceptions that have not yet been corrected

- Trend of rate of return on investments

- Unrealized gain or loss resulting from appreciation or depreciation in the market value of securities

- Aggregate commitments to purchase securities or make other payments to broker/dealers in a manner to permit adequate cash forecasting

- Interest cost and interest earnings from reverse repurchase agreement transactions, if the City continues to use reverse repurchase agreements as a short-term investment vehicle

Appropriate items in the report should be compared to budget (if it exists), prior month results and the same month in the previous year.

The monthly Report should include all transactions for all investments whether or not the transaction has been finally settled.

. As recommended in previous sections, the City should retain the services of an independent investment advisor to:

- Assist City personnel with the evaluation of the performance of the City's portfolio as reflected in the investment reports, and

- Educate the City Council and City management on the nature of the City's investment activity so that they may effectively review the investment reports.

- The City should develop procedures for reviewing investment reports to ensure that, at a minimum, the Report is reviewed in detail by the Director of Finance and the Chief of Treasury, and in summary by the City Manager's office. These review procedures should be incorporated into the City's investment policy as discussed in Section II of this report, "Investment Policy." If the City's new investment policy calls for the participation of investment committees or outside investment advisors, as we believe it should, the policy should also include provisions to ensure that these groups and individuals also review the report on a timely basis with an appropriate degree of detail.

- Review and supervision of Treasury division officers.

Findings - Without Specific Recommendations

The following findings are based upon our interviews with Treasury division employees responsible for making investment decisions and reporting investment activity:

- Trading, as evidenced by "pair-off" transactions, was performed without fully understanding the risk that was inherent in the investment strategy when interest rates begin to rise.

- "Open reverse" transactions (financing the acquisition of a security by initiating a reverse repurchase agreement collateralized by the security itself) were initiated only after a broker suggested how the transaction could be used to prevent the City from having to purchase a security at a cost that was now above its market value. The broker instructed City personnel as to how to complete the City confirmation and initiate the transactions. No detailed investigation regarding the propriety of such transactions, the risk involved, or their implications for accounting or reporting was performed.

- The investment officers did not understand the nature of the "open reverses" that they had initiated until October 1983, when several brokers began to demand payment in settlement of the reverse repurchase agreements that they held with the City. These demands were triggered by the bankruptcy of the San Jose Unified School District. Prior to this time, they were not aware that these reverse repurchase agreements could be called at the broker's discretion.

- Treasury employees invested in Stripped Coupons (interest coupons of United States Treasury Bonds sold separately from the principal of the security) after reading about them in a trade publication. At the time the investment was made, they did not know whether these were appropriate investments or whether there was an active secondary (resale) market. Since an active secondary market is not available, the coupons must now be held until maturity.

- We believe that the findings described above show that the Treasury officers responsible for making investment decisions did not have the requisite expertise and knowledge to manage the City's investment portfolio, and that proper review and supervision of their work would have revealed their lack of expertise.

V. INTERNAL AUDIT REVIEW OF INVESTMENT PROGRAM

V. INTERNAL AUDIT REVIEW OF INVESTMENT PROGRAM

The Office of the City Auditor conducted an examination of the investment program of the Finance Department covering activities in Fiscal Year 1981-82, including selected transactions in Fiscal Year 1982-83. A report on that audit was issued on January 31, 1983 (Audit Report No. 3-42C-1). We have reviewed that report and several documents prepared prior to issuance of the final report. We have reviewed this audit report and follow-up activities relative to the Audit Review and Follow-up Procedures defined in Section 196 of the Administrative Manual, City of San Jose. Our findings are summarized below in chronological order by individual responsibility:

Summary of Section 196 Procedures	Findings
A. CONDUCT OF AUDIT	
City Auditor Responsibilities	
Schedule, plan and conduct departmental review.	Audit review conducted for FY 1981-82. Audit objectives, scope, findings and recommendations were documented.
B. CONDUCT OF AUDIT FOLLOW-UP PROGRAM	
City Auditor Responsibilities	
Set tentative implementation priorities for each recommendation.	Discussion drafts prepared in December 1982, including tentative implementation priorities.
Meet with Department Head to discuss findings and define formal and informal recommendations.	Second discussion draft prepared in January 1983.
Prepare discussion draft of audit report, including identification of recommendations for priority implementation. Send copies to OMB, Deputy City Manager,	

Summary of Section 196 Procedures	Findings
B. <u>CONDUCT OF AUDIT FOLLOW-UP PROGRAM (CONTINUED)</u>	
<u>City Auditor Responsibilities (continued)</u>	
Department Head and other departments affected by the Audit findings.	
Request OMB to schedule the Exit Conference.	Exit Conference held January 4, 1983.
<u>OMB Responsibility</u>	
Review discussion draft with Audit staff as necessary. Determine whether an Exit Conference is needed.	
Schedule Exit Conference with City Auditor, audited department, appropriate Deputy City Manager, and other recipients of the discussion draft, within ten working days of receiving draft, or inform City Auditor that an Exit Conference is not needed.	Exit Conference held January 4, 1983.
<u>Deputy City Manager Responsibility</u>	
Ensure that Audit recommendations are effectively implemented by organizational units under their direction. At the Deputy City Manager's option, participate in Exit Conferences and give direction to Department Head concerning priority and scheduling of audit recommendation	Deputy City Manager elected not to participate in Exit Conference. Since there were no disagreements concerning the Audit recommendations and their implementation, there were no further meetings scheduled. The Head of the Finance Department worked directly with the OMB and City Auditor.

Summary of Section 196 Procedures	Findings
B. <u>CONDUCT OF AUDIT FOLLOW-UP PROGRAM (CONTINUED)</u>	
<u>Deputy City Manager Responsibility (continued)</u>	
implementation. At their option, participate in meetings to resolve disagreements over audit recommendations and their implementation. If Deputy City Managers elect not to attend Exit Conferences and/or meetings, they shall authorize Department Heads to work directly with OMB and City Auditor.	
<u>Auditor, OMB, City Manager, Department</u>	
Hold Exit Conference. Discuss recommendations and their proposed classifications.	Exit Conference held January 4, 1983. Notes from Exit Conference filed with OMB. Second Exit Conference waived (as authorized).
<u>City Auditor Responsibility</u>	
Issue formal Audit Report, indicating priority assigned to each recommendation. Distribute copies in accordance with the City Auditor's Report Distribution List. Ensure that copies are sent to OMB, the appropriate Deputy City Manager, and the affected Department Heads.	Formal Audit Report (No. 3-42C-1) issued on January 31, 1983 by City Auditor to City Manager. Report put in routing on February 3, 1983 for distribution to Deputy City Manager, Director of Finance, Director of OMB, Chief of Accounting division and Chief of Treasury division. Four recommendations were listed in the report.

Summary of Section 196 Procedures	Findings
B. CONDUCT OF AUDIT FOLLOW-UP PROGRAM (CONTINUED)	
Department Responsibility	
Prepare response to Audit Report indicating what corrective action has been or will be taken and the implementation target date for each recommendation. Address the response to the Director of OMB with copies to the appropriate Deputy City Manager and City Auditor no later than two weeks from the distribution date noted on the Audit Report.	A response to Audit Report No. 3-42C-1 was issued by the Director of Finance to the Director of OMB on February 10, 1983. Copies were also sent to the Deputy City Manager, City Auditor, Chief of Accounting, and Chief of Treasury. Recommendation No. 1 regarding Program Compliance was noted in the response by the Director of Finance as having been implemented February 1, 1983. The response to Recommendation No. 2 regarding maximizing investable funds stated that an amendment to state law was required. Such an amendment was before the legislature. The response by the Director of Finance to Recommendation No. 3 regarding Reverse Repurchase Agreements was that the recommendation was scheduled for implementation by April 1, 1983. The body of the Internal Audit Report contained a statement that, "We recommend that a subsidiary record of transactions be maintained showing as a minimum: 1. Description of the security 'sold' in a reverse repurchase agreement. . .

Summary of Section 196 Procedures	Findings

B. CONDUCT OF AUDIT FOLLOW-UP PROGRAM (CONTINUED)

Department Responsibility (continued)

2. Description of the security purchased with the reverse repurchase proceeds. . .

3. Monthly interest cost on the reverse repurchase agreement."

This wording was not included in the wording of Recommendation No. 3 on Reverse Repurchase Agreements and was consequently not included in the follow-up activities under S196. The recommendation contained in the wording described above was not implemented. Recommendation No. 3 was implemented as worded.

Recommendation No. 4 regarding "Pair-Off" transaction was noted in the response by the Director of Finance as having been implemented.

Management Analysis Supervisor Responsibility

Summary of Section 196 Procedures	Findings
Conduct Audit Follow-up Program operations so that program objectives are accomplished, and coordinate interdepartmental activities necessary to effect timely implementation of Audit recommendations.	Financial Analysis division of the Finance Department met with the Chief of Treasury to inquire whether recommendations had been implemented. Management Analysis Supervisor requested and received confirmation of implementation

Summary of Section 196 Procedures	Findings

B. CONDUCT OF AUDIT FOLLOW-UP PROGRAM (CONTINUED)

Management Analysis Supervisor Responsibility (continued)

status of audit recommendations from the Director of Finance. This information was contained in the semiannual Audit Recommendation Status Report (2/28/84).

OMB and City Auditor's Responsibility

Summary of Section 196 Procedures	Findings
Semiannually, a joint report to Council on the implementation status of Audit recommendations is to be prepared jointly by the Director of OMB and the City Auditor.	An Audit Recommendation Status Report (2/28/84) was prepared by Kent South for Recommendation No. 2 (the only recommendation noted as not implemented). Recommendation No. 2 regarding Maximizing Investable Funds was noted as not implemented because of a failure of the banking community to allow the type of arrangement called for in the recommendation.

The notes from the Exit Conference of January 4, 1983 called for an ongoing investment program audit. The audit workplan for FY 83-84, presented to the Council by the City Auditor in September 1983, included the development of a continuous audit approach for the City's investment program and the implementation of that audit approach. The research and development work was begun in April 1984 and continued until May 23, 1984, when it was postponed because of developments in the Finance Department.

We have not made any inquiry into the activity conducted by the Internal Auditors in April and May 1984, nor whether that review did or should have revealed the nature of investment activity.

Other Findings

- With respect to the report submitted January 31, 1983, the following objectives were stated in the report:

  - Determine that the investment program has complied with the applicable law

  - Determine that the investment program maximizes investible funds and earnings

  - Determine that the monthly Treasury reports are complete, accurate and reliable

  Since the report was issued approximately four months prior to the passing of City Council Resolution No. 56549, the reverse repurchase transactions that were specifically identified and discussed in the body of the report had not been brought to the attention of the City Council for review of the manner in which the City was to use such transactions. (See Section VI "City Council Resolutions.")

  The second stated objective of the report is directly in conflict with investment policy used by the Treasury division, which places safety and liquidity of the investment before its yield.

  The monthly Treasury reports did not disclose significant investments in securities, obligations under reverse repurchase agreements and cash disbursements made to dealers in connection with the unrecorded transactions. This was not disclosed in the Auditor's report. The items mentioned above existed after October 1982; however, it is not known whether such unrecorded transactions existed during the periods reviewed by the Auditors.

  The field work supporting the audit report was performed in the summer of 1982 and tested investment transactions from the months of July and December 1981; however, the report was not issued until early 1983. We believe that the usefulness and effectiveness of the internal audit function is severely impaired by issuing a report over a year after the end of the periods tested to support the report.

Recommendations

- The nature of the activities undertaken in the Treasury division were complex, requiring a detailed knowledge of both the mechanics and implications of investment activity and reporting. When auditing areas such as Treasury and investments, we recommend that the Internal Auditors employ outside experts who are familiar with the subject matter to help plan the scope of the work, determine the tasks to be performed and review the findings.

- The procedures under Section 196 are structured and followed in such a manner that compliance with the recommendations is determined by verbal and written inquiry of the Division Chief concerned. There is no verification that the recommendations have been implemented effectively. We recommend that Section 196 be amended so that implementation of Class 1 and 2 recommendations is verified as being effective. This should be the responsibility of the Director of the Office of Management and Budget, and should include a review of the procedure or action implemented to ensure that it has been implemented effectively. In addition, we recommend that the City Auditor include a follow-up audit of Class 1 and 2 recommendations in the audit program for the next fiscal year.

- Reports for all audit projects should be issued in a timely manner after completion of the field work. Section 196 of the Administrative Manual should be amended to include specific guidelines regarding timely completion of audit reports and audit follow-up procedures.

- Audit reports should be carefully reviewed before being issued to ensure that all critical findings are appropriately summarized in the recommendations section.

VI. RESPONSIBILITY AND AUTHORITY RELATED TO INVESTMENT ACTIVITY

VI. RESPONSIBILITY AND AUTHORITY RELATED TO INVESTMENT ACTIVITY

We reviewed the following for indications of both the responsibility and authority for City investment activity:

California Government Code, specifically Sections 53601, 53602, 53607, 53608 and 53635 [CGC]

Charter of the City of San Jose, as amended through December 13, 1982 [CC]

City Council Resolutions, specifically numbers 56549 (May 31, 1983) and 50789 (October 3, 1978) [CCR]

San Jose Municipal Code

Treasury Division Procedural Manual [TDPM]

Treasury Division Investment Policy [TDIP]

In addition, we reviewed minutes of the meetings of the following bodies for the period from July 1, 1982 to approximately April 30, 1984:

City Council

Finance Committee of the City Council

Rules Committee

Treasury division staff meetings

Reports to the City Council

Findings

- The City Manager is to keep the Council fully advised as to the financial condition and future needs of the City and make recommendations to the Council that he or she feels are necessary [CC - S701(g)]. To help the City Manager meet this responsibility, the Director of Finance is required to present a monthly report to the Manager that discloses the financial condition of the City [CC - S806(a)].

- The City Charter does not define the term "financial condition."

- Based upon interviews with Accounting and Treasury division personnel, we found no evidence that reports disclosing the City's financial condition, as this

term is generally understood, were prepared at any time during the year, except in conjunction with the annual external audit.

- At the direction of the City Manager, the 1983-1984 work plan for the Accounting division included a task to develop a monthly financial report. The report format that was requested was to present the City's actual revenues and expenditures compared to budgeted amounts. Significant fluctuations were to be explained. Work on this project started in February 1984.

- In June 1984, the City Manager instructed the new Acting Finance Director to make the development of the report a top priority.

- The first report prepared as a result of this project will be presented to the City Council in October 1984.

Recommendation

- We concur with the City Manager's decision to make such a report a priority item and suggest that the development process remain a priority until accurate and timely data as described by the City Manager can be generated on a monthly basis.

Supervision of Divisions

Findings

- The Treasury division's procedural manual has not been ratified or reviewed by the Finance Director. The procedural manual contains detailed procedures describing how to handle unrecorded obligations and investments. Had the Finance Director carefully reviewed the procedural manual, he would have been aware of the nature of the City's investment activity.

- The procedural manual describes the procedures for tracking open reverse repurchase agreements and specifically mentions keeping track of the amounts owed under the agreements and the interest paid as a result of them [TDPM - 100.54 - 5].

Recommendation

- Divisional policies and procedures should be reviewed, understood, ratified and adhered to by the individuals responsible for the function. Responsibility is set within the City Charter.

City Council Resolutions

Findings

- City Council Resolution Nos. 56549 (effective May 31, 1983) and 50789 served as the Council's authorization for investment activity from October 3, 1978 to the present.

- These resolutions authorize the City Treasurer to invest in those securities specified by CGC 53601 and 53602. These codes are incorporated by reference, rather than by repeating the desired language from the code sections in the City Council resolutions.

- On August 13, 1982, the CGC was changed to allow city governments to use reverse repurchase agreements in their investment strategy.

- As a result of merely incorporating CGC 53601 and 53602 by reference in its resolution, City policy was changed without the specific action or the knowledge of the City Council.

Recommendation

- City Council resolutions should repeat the desired CGC sections and not merely incorporate such sections by reference. As a result, subsequent changes to the CGC will not change City policy, unless the change is discussed by the City Council and then included in a revised Council resolution.

Other Findings Without Specific Recommendations

Concerning City Council:

- CCR No. 56549 requires "the Director of Finance shall make a monthly report of such transactions [those transactions authorized by the resolution] to this Council." Monthly Treasury reports were prepared;

however, these reports were discussed or reviewed only superficially with the Finance Director and not with the City Council, as directed by the resolution.

- Council members expressed their view that the City Manager should put items on the Council agenda for discussion if any problems existed. One Council member indicated that the form and content of the monthly report had never been explained to the members, nor was any such explanation requested.

Concerning the Finance Director

- The Finance Director is to invest funds in accordance with all applicable laws and ordinances [CC - S806(b)] and be responsible for all functions of the Finance Department [CC - S806].

- From October 1982 through May 1984, significant cash disbursements were made to brokers, which were not fully understood by the Accounting division and incompletely reflected in the records of both the Treasury and Accounting divisions. The Finance Director's supervision of these disbursements and assessment of their impact upon the City's financial condition were both incomplete.

EXHIBITS

Note: These exhibits have been prepared from City documents and do not include all transactions.

EXHIBIT A

CITY OF SAN JOSE

MATURITY IN YEARS

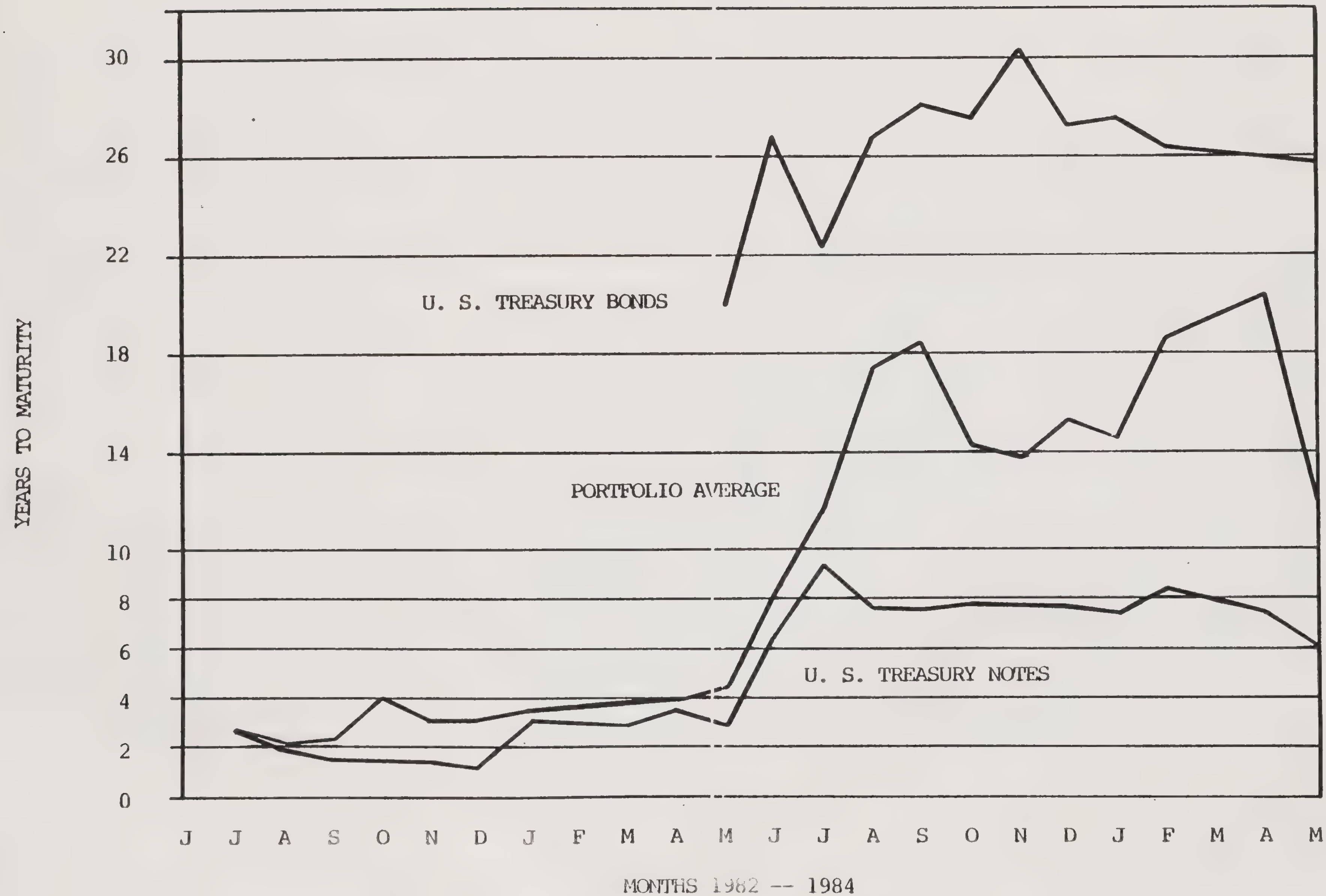


EXHIBIT B

CITY OF SAN JOSE

PORTFOLIO COMPOSITION

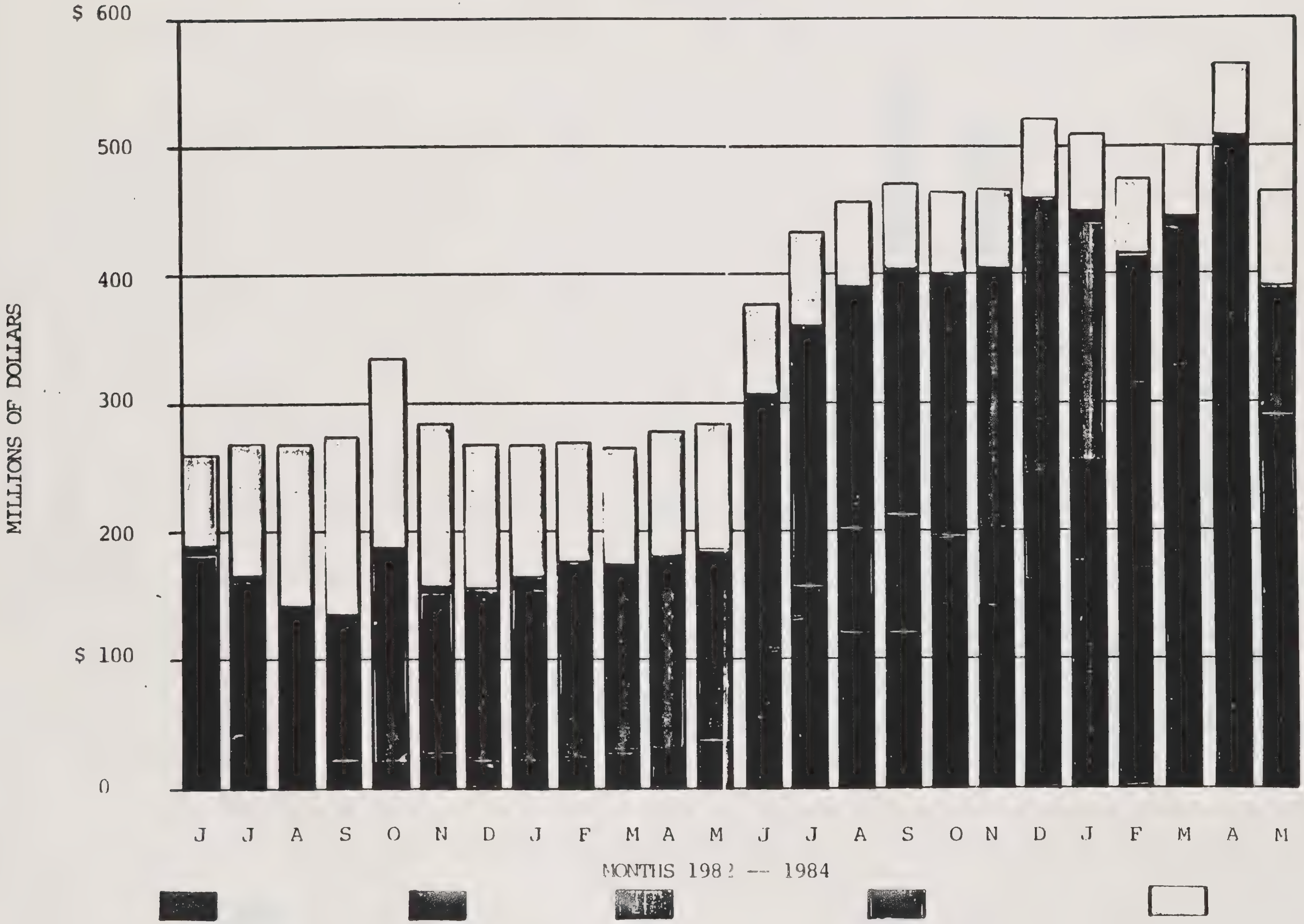
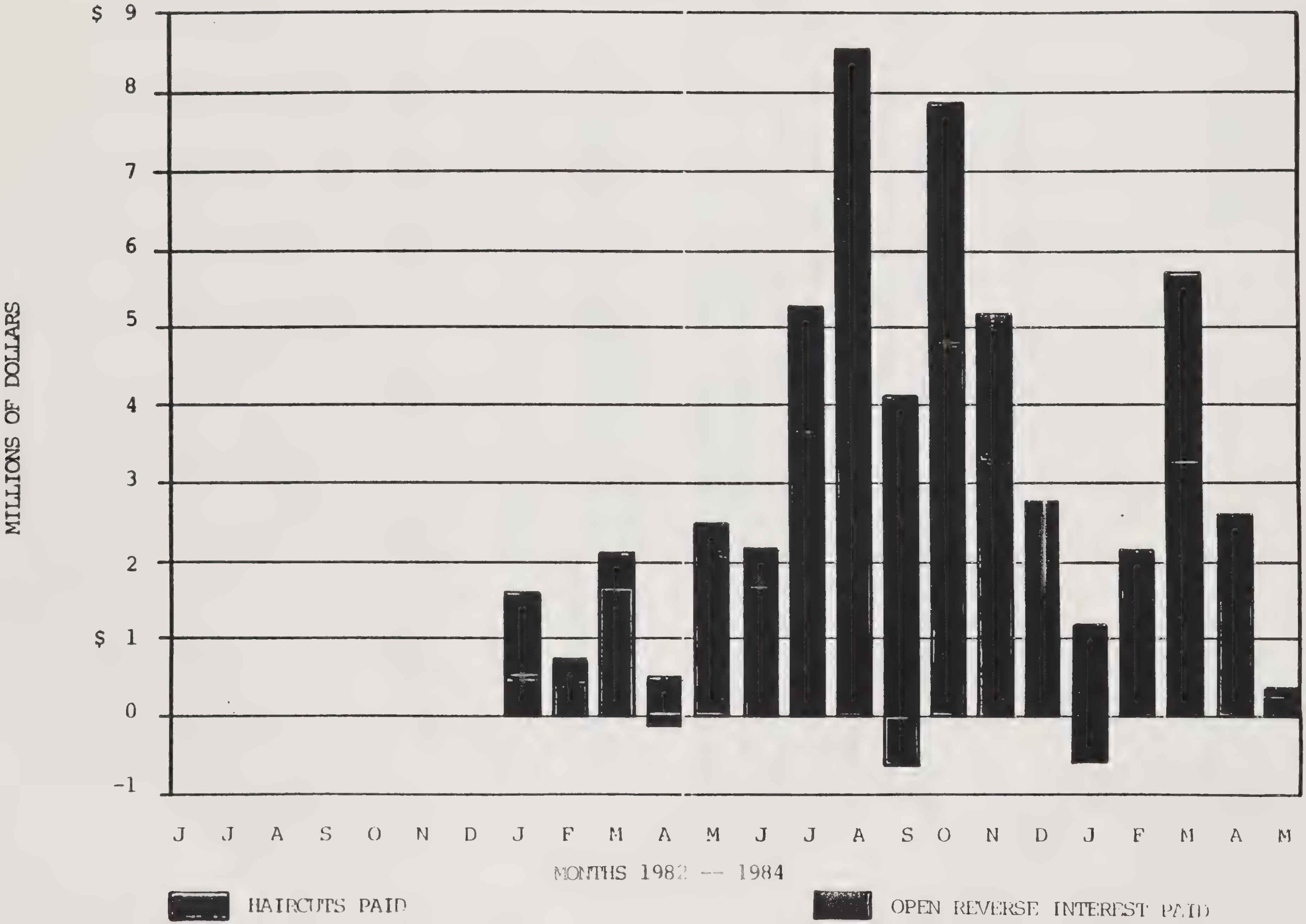


EXHIBIT C

CITY OF SAN JOSE

HAIRCUTS & OPEN REVERSE INTEREST PAID



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Honorable Mayor and City Council
City of San Jose

We enclose our report on our review of the procedures, policies and controls related to the investment activity under the control of the Treasury division at the City of San Jose (the City). We reviewed the procedures, policies, and controls related to the three portfolios that Treasury division personnel identified as being the pooled investments of the funds set out in our contract with the City. These portfolios are described below:

- Pooled cash and investments portfolio, which serves as a common investment pool, except for the short-term portion of the City's two retirement plans
- Federated City Employees Retirement Plan, the short-term portion of which is under Treasury division control
- Police and Fire Department Retirement Plan, the short-term portion of which is under Treasury division control

We have not performed any procedures to verify that these pooled investments were the only investments under the control of the Treasury division; however, during the course of our review nothing came to our attention that would indicate that there were other pooled investments under Treasury division control.

Our procedures consisted of:

- Interviews with certain current and former employees of the Finance Department, the City Manager's Office, the Office of Management and Budget, Internal Audit, and certain City Council members

- Review of the City's methods of initiating, completing, documenting, accounting for, and reporting on investment activity

- Review of portions of the City's policy and procedures manuals for the Treasury, Accounting, and Internal Audit divisions

- Discussions with certain City consultants regarding various aspects of the City's investment management program

This report contains our detailed findings and recommendations regarding the procedures, policies, and controls related to the City's management of its investment portfolios. It is organized into the following sections:

I. Council Summary

II. Investment Policy

III. Control Issues

IV. Management Reporting and Review

V. Internal Audit Review of Investment Program

VI. Responsibility and Authority Related to Investment Activity

Because the above procedures did not review all controls affecting the pooled investments and are more limited than would be necessary to express an opinion on the internal control procedures of the City, we do not express an opinion on the system of internal control of the City or the controls over the pooled investments. Had we performed a review of the

system of internal control of the City or had we performed an examination of the financial statements of the City in accordance with generally accepted auditing standards, additional items might have come to our attention that we would have reported to you. This report is intended solely for the use of City management (including the City Council) and should not be used for any other purpose.

We would like to thank all the City officials, employees, and consultants who cooperated with us during this review.

Arthur Young & Company